80-2031

No.

Office-Supreme Court, U.S.
FILED
MAY 28 1981
ALEXANDER L. STEVAS,
CLERK

IN THE

Supreme Court of the United States

October Term, 1980

WILLIAM J. O'HARE and PATRICIA E. O'HARE,
Petitioners,

against

COMMISSIONER, INTERNAL REVENUE SERVICE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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PETITION FOR A WRIT OF CERTIORARI.

Petitioners, William J. O'Hare and Patricia E. O'Hare, pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit, dated February 24, 1981, affirming a decision of the United States Tax Court, dated February 6, 1980, and the Order made thereon, dated February 19, 1980.

Petitioners were determined by the United States Tax Court to be deficient in income tax due for the tax year 1974. The amount of such deficiency is $10,131, determined by respondent on audit of the petitioners in 1978. The basis for the determination of the United States Tax Court was a finding that a certain real estate transaction resulted in ordinary income to the petitioners, not in a capital gain as petitioners contend.

Petitioners timely sought review of the respondent's determination in the Tax Court on June 13, 1978. A trial upon the matter was held before the Tax Court on May 21, 1979. The Tax Court filed its Memorandum Findings of Fact and Opinion on February 6, 1980, and entered its Decision and Order on February 19, 1980. Petitioners filed their Notice of Appeal to the United States Court of Appeals for the Second Circuit on May 20, 1980. The appeal was heard by the United States Court of Appeals for the Second Circuit on October 6, 1980, and a decision thereon was rendered on February 24, 1981.

QUESTIONS PRESENTED.

There are two questions presented in this petition:

1. Whether the Commissioner of Internal Revenue, in applying the "substance over form" rule in reviewing a taxable transaction, can lawfully disregard the risks, consequences and obligations imposed by State law upon a taxpayer.

2. Whether the Commissioner of Internal Revenue, in applying the "substance over form" rule in reviewing a taxable transaction, can disregard the actual risks, consequences and obligations imposed upon the taxpayer and third parties and to alter the legal relations between the taxpayer and such parties so as to create a more taxable situation.

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I. The instant case presents the question of the extent to which the Commissioner of Internal Revenue, in applying the "substance over form" rule in reviewing taxable transactions, can disregard the consequences, risks and obligations to the taxpayer created by local law. This is a substantial question of Federal Tax law which has not

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yet been, but should be, settled by the court and is important to the administration of the tax laws of the United States 14

II. The decision of the United States Court of Appeals for the Second Circuit in the instant case is in seeming conflict with the decision of the United States Court of Appeals for the Fifth Circuit in Murry v. Commissioner of Internal Revenue, 601 F. 2d 892 (1979), and other cases in the Fifth Circuit concerning the effect of State law in determining taxable incidence 24

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III. The decision of the Court of Appeals for the Second Circuit in the instant case, affirming the decision of the Tax Court, is in direct conflict with, and a marked departure from, this court's decision in Frank Lyon Company v. United States, 435 U. S. 561 (1978), and, unless reviewed by this court, may result in substantial uncertainty in the administration of the Tax Laws of the United States 29

Conclusion. For all of the above reasons, it is respectfully prayed that the writ of certiorari be granted . . 36

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OPINIONS BELOW.

The opinion of the United States Court of Appeals for the Second Circuit, affirming the Decision and Order of the

United States Tax Court is reported as *William J. O'Hare and Patricia E. O'Hare v. Commissioner of Internal Revenue*, 641 F. 2d 83 (1981). This opinion is included as Appendix A.

The opinion of the United States Tax Court affirming the determination of the respondent is reported as *William J. O'Hare and Patricia E. O'Hare v. Commissioner of Internal Revenue*, 39 T. C. 1006 (CCH Decisions 36.760 M). This opinion is included as Appendix B.

JURISDICTION.

The Order of the United States Court of Appeals for the Second Circuit affirming the Decision and Order of the United States Tax Court was entered on February 24, 1981. The jurisdiction of this Court is invoked under 28 U. S. C. Section 1254 (1).

STATEMENT OF THE CASE.

Petitioner William J. O'Hare[1] is currently and was, in 1974, a practicing attorney duly licensed in the State of New York. In 1973, and in 1974, a New York State corporation named IX Investors, Inc. (hereinafter "Investors"), was among petitioner's clients. Investors was primarily engaged in the business of the purchase and sale of real property for investment and profit. O'Hare, as the corporation's attorney, was entrusted with the care of corporate legal interests, and he, himself, had no beneficial, equitable or management interest in Investors. That responsibility was entrusted to the then president of Investors,

1. Petitioner Patricia E. O'Hare was a party in the proceedings below solely by reason of having filed a joint return with petitioner William J. O'Hare, her spouse. The pertinent issues herein concern only petitioner William J. O'Hare, and references to "petitioner" in the singular are intended to reflect that fact.

Richard Dean, who was largely involved in determining which investments the corporation would make and the means to facilitate and execute the transactions.

Without having first secured or explored the possibility of securing mortgage financing, on or about November 21, 1973, Investors entered into a contract for the purchase of certain real property known as the Ferry Farms. The purchase price was $248,000, and Investors paid $24,800 as the down payment thereon in accordance with the purchase contract.

Having improvidently committed itself to the purchase and having expended the down payment, Investors then began to seek mortgage financing. Its efforts proved markedly unsuccessful. Prospective lenders seemed not exactly enthralled by prospects of the risky transaction

and reluctant to advance funds to a corporate entity without adequate individual guarantees, which the principals of Investors could not provide. Dean, on behalf of Investors, offered to pay up to a $70,000 return to any person willing and able to arrange financing of the transaction. Despite this offer, no takers could be found for this venture, considered to be risky in the local financing community.

Dean subsequently made contact with the Federal Land Bank in Hudson, New York, in regard to financing the Ferry Farms purchase. The Federal Land Bank expressed some initial interest in providing the financing needed by Investors, if an individual of sufficient net worth would be willing to guarantee the corporate obligation, since Investors' financial

statement was inadequate to assure the Bank of security.

At this point, Dean approached the petitioner William J. O'Hare, heretofore the corporation's attorney, to request whether O'Hare would be willing to provide the guarantee required by the Federal Land Bank. Petitioner gratuitously agreed to guarantee the proposed obligation, submitted his financial statement to the Federal Land Bank, and then negotiated personally with Bank personnel relative to the loan. The Bank, wishing further security in the transaction before it would proceed, required O'Hare not to become a mere guarantor, but the actual borrower of and the obligor for the funds, holder of title to the real property, and mortgagor of the premises.

O'Hare returned to Investors with the Bank's requirements. At that time, O'Hare and Investors agreed to consummate the transaction involving the Ferry Farm as, for want of a better description, joint venturers. O'Hare would take title to the premises; become personally obligated to the Federal Land Bank, as it required, on a bond in the sum of $200,000; and, in addition to O'Hare's personal obligation on the bond, would secure the $200,000 obligation by a mortgage upon the Ferry Farm. O'Hare would then receive a certain, agreed upon share of the profits upon an anticipated subsequent sale of the Ferry Farm. O'Hare wished to have his initial investment of $200,000 returned, plus some additional profit, and Investors wished to realize a profit, over O'Hare's, for its principals.

On or about December 23, 1973, by written instrument, Investors assigned its executory contract rights in the Ferry Farm to O'Hare.[2] The written assignment further provided that after he took title, should a third-party purchaser for the property be located, O'Hare would convey[2] (The written agreement provided for "re-conveyance" to Investors. Since Investors never actually held title to the property and had only executory contract rights in the Ferry Farm, this bit of concededly bad draftmanship is more accurately read as the word "convey" or "conveyance.") the property to Investors for re-conveyance to such a purchaser. Should the re-con-

2. The pertinent parts of this agreement are set forth in the opinion of the United States Court of Appeals for the Second Circuit as footnote 2.

veyance to a third-party purchaser take place within four (4) months of O'Hare's taking title to the Ferry Farm, he would be entitled to return of his $200,000 investment, plus $25,000 as his share of the profits. Should such re-conveyance take place within eight (8) months of O'Hare's taking title, he would be entitled to return of his $200,000 investment, plus $50,000 as his share of the profits. Finally, should such re-conveyance take place more than eight (8) months after O'Hare took title, he would be entitled to return of his $200,000 investment, plus $75,000 as his share of the profits. The written agreement additionally provided that if a portion or parcel of the Ferry Farm was re-conveyed with O'Hare's consent, he would accept a *pro-rata* of his agreed profit.

In consideration of the assignment of contract by Investors and of his receipt of profits for his risk, and in order to preserve Investors' contingent interest in the Ferry Farm, O'Hare agreed to not further encumber the property with mortgages additional to that of the Federal Land Bank. Finally, Investors agreed by the written instrument to bear all closing costs incidental to the sale to O'Hare, plus the payment of the purchase price of $248,000, less the mortgage proceeds and down payment made by Investors. In sum and substance, O'Hare invested $200,000 into the Ferry Farm transaction, while Investors contributed $48,000, plus closing costs.

Shortly after the written assignment, petitioner William J. O'Hare executed a note as personal obligor to the Federal

Land Bank in the sum of $200,000; he took title to the Ferry Farm personally; and he personally executed a mortgage upon the Ferry Farm in favor of the Federal Land Bank in order to secure his personal obligation to the Bank.

Both O'Hare and Investors began to seek a third-party purchaser for the Ferry Farm. Dean, on behalf of Investors, finally introduced a buyer of the property at a sale price of $335,000. On or about August 14, 1974, O'Hare directly conveyed the Ferry Farm to this third-party purchaser by bargain and sale deed with covenants against grantor's acts, executed by him personally.

O'Hare did not convey the property to Investors upon this third-party sale as provided in the agreement, but with the concurrence of Investors, sold the

Ferry Farm directly.[3] Accordingly, O'Hare was entitled to receive $250,000 from Investors, representing $200,000 as the return of his investment and $50,000 as his share of the profits. Investors' share was the remaining $85,000, less incidental closing costs. In fact, since O'Hare had sold the property directly, his $200,000 personal commitment to the Federal Land Bank had been paid at the closing so that clear title could be conveyed, and the remaining sale proceeds and profits were divided between Investors and O'Hare. While O'Hare was entitled to $50,000 as his share of the profits, had he elected to receive the full amount, Investors

3. The fact that O'Hare sold the property directly to the third-party purchaser, rather than conveying it to Investors, who, in turn, would re-convey to the purchaser, is more a matter of expedience than substance. It does not materially alter the issues in this case.

would not have realized its anticipated reasonable return. Accordingly, O'Hare retained only $40,000 as his profits, the remainder of the sale proceeds going to Investors.

On Schedule D of their joint income tax return for the tax year 1974, petitioners William J. O'Hare and Patricia E. O'Hare reported the $40,000 profit from the Ferry Farm transaction as a long-term capital gain from the sale of a capital asset. Respondent, upon audit of the petitioners return, determined the $40,000 to be ordinary income derived from Investors as a fee.

Petitioners sought review in the Tax Court, which upheld the respondent's determination on February 16, 1980. Petitioners then appealed the decision of the Tax Court to the United States Court of

Appeals for the Second Circuit, which affirmed the decision of the Tax Court, with Judge Mansfield dissenting, on February 24, 1981.

I. THE INSTANT CASE PRESENTS THE QUESTION OF THE EXTENT TO WHICH THE COMMISSIONER OF INTERNAL REVENUE, IN APPLYING THE "SUBSTANCE OVER FORM" RULE IN REVIEWING TAXABLE TRANSACTIONS, CAN DISREGARD THE CONSEQUENCES, RISKS AND OBLIGATIONS TO THE TAXPAYER CREATED BY LOCAL LAW. THIS IS A SUBSTANTIAL QUESTION OF FEDERAL TAX LAW WHICH HAS NOT YET BEEN, BUT SHOULD BE, SETTLED BY THE COURT AND IS IMPORTANT TO THE ADMINISTRATION OF THE TAX LAWS OF THE UNITED STATES.

It has been long-settled in this Court, as well as the lower Federal Courts, that, in determining tax treatment, the Commissioner of Internal Revenue need not be bound by the formal character of a transaction but may look beyond the form to the substance. See, e.g., *Commissioner v. Hansen*, 360 U. S. 446 (1959); *Commissioner v. Court Holding Company*, 324 U. S.

331 (1945); *Northwest Acceptance Corporation v. Commissioner*, 58 T. C. 836 (1972), aff'd 500 F. 2d 1222 (9th Cir. 1974). The United States Court of Appeals for the Second Circuit, the United States Tax Court, and the Commissioner, in attempting to apply the "substance over form" rule to the instant case have swept away with some facility the substantive real property law of the State of New York. At issue and worthy of review by this Court is the extent to which the Commissioner of Internal Revenue can disregard interests created by well-settled State statutory law and State case law in transforming petitioner from a fee owner of real property to a "mere guarantor" of another's obligation, and "accommodation title holder" of real property.

Following this Court's ruling in *Commissioner of Internal Revenue v. Court*

Holding Company, supra, numerous lower Federal courts have applied the "substance over form" test in finding taxable incidence to transactions which might otherwise, by their strict formal nature, result in tax avoidance. See, e.g., *Waterman Steamship Corporation v. Commissioner of Internal Revenue*, 430 F. 2d 1185, at 1193 (5th Cir. 1970); *Republic Petroleum Corporation v. United States*, 613 F. 2d 518 (5th Cir. 1980). To what extent, however, the Commissioner can reach to sweep away the economic substance of a transaction when viewed through the formal economic consequences of State law is an issue which has not been put squarely before this Court.

In prior cases involving the "substance over form" analysis, this Court and lower Federal courts have repeatedly

found that when transactions involve a mere drawing up of and shuffling of papers to achieve a change in the form of the transaction, but not its true character, the Commissioner is entitled to view the reality of the situation as opposed to its superficial appearance. See, e.g., *Gregory v. Helvering*, 293 U. S. 465 (1935); *Court Holding Company v. Commissioner of Internal Revenue*, *supra*; *United States v. General Geophysical Company*, 296 F. 2d 86 (5th Cir. 1961); *Lynch v. United States*, 192 F. 2d 718 (9th Cir. 1951).

This Court additionally has seemingly suggested that the tax consequences of a given transaction, although governed by Federal law, may be very greatly affected by the State law economic consequences of that transaction. *Collins v. Commissioner*

of Internal Revenue, 393 U. S. 215 (1968); *United States v. Davis*, 370 U. S. 67 (1962). In both *Davis* and *Collins*, this Court, in determining tax treatment of conveyances of property between spouses in dissolved marriages, looked to and placed great reliance upon the property interests created by State law in the transferor and transferee of the property. It was the property interests created under local law that the Court found determinative in fixing tax treatment of the conveyances.

The instant case presents directly the issue of the extent to which property interests created in and economic consequences to a taxpayer can be disregarded by the application of the "substance over form" rule. As Judge Mansfield, dissenting in the Court of Appeals decision

below, aptly noted, the operation of State law created real and substantial economic consequences and risks incident to the transaction totally different from those of a mere lender, while the operation of hindsight applied by the respondent, the Tax Court, and the majority below, in reviewing the transaction, transformed petitioner into a "lender."

As in *United States v. Davis, supra,* and in *United States v. Collins, supra,* the operation of State law in the instant case operated to create more than mere formal paper shuffling. Substantial property interests and risks attendant thereto were created and economic consequences flowed by reason of the transaction, all of which the Commissioner and the Courts below chose to disregard in applying the "substance over form" rule:

(1) When IX Investors, Inc. assigned its executory purchase contract rights to petitioner, under New York State law it relinquished any right or claim in the property. N. Y. General Obligations Law §§ 13-105 and 13-109 (McKinney's 1978);[1]

(2) When petitioner O'Hare accepted the delivery of the deed to the Ferry Farm, he became the equitable and legal owner thereof. New York Real Property Law § 244 (McKinney's 1966); New York Lien Law § 2(3) (McKinney's 1977);

(3) As the owner of the real property, petitioner held more than the piece of paper known as a deed. He was personally liable, without recourse

1. The applicable provisions of New York State Law are set forth in pertinent part in the appendices hereto.

to IX Investors or to anyone else, for any tortious injury upon the property. *Basso v. Miller*, 40 N. Y. 2d 233 (1976). He was the only person who could convey any interest in the property, including encumbrances thereon, New York Real Property Law § 240-b(1) (McKinney's 1966). The property would become a part of his estate should he become deceased, New York Estate Powers and Trust Law § 1-2.6; 26 U. S. C. § 2031 and § 2033.[2]

2. The position of the Commissioner in applying the "substance over form" rule raises an interesting speculative question. Would the Commissioner, for purposes of estate taxation, had O'Hare died while owner of the property, included the property as part of the estate? A similar question was similarly posed, but left unanswered, by Mr. Justice Douglas' dissenting opinion in *Knetsch v. United States*, 364 U. S. 361, 371 (1960). A similarly interesting speculative question is whether the Commissioner would look to the property for the purpose of imposing a lien in the
(footnote continued next page)

(4) As owner of the real property, petitioner was personally liable, without recourse to IX Investors or to anyone else, for any real property taxes owed thereon. New York Real Property Tax Law § 926 (McKinney's 1977);

(5) As owner of the property, petitioner was the only one capable of conveying a mortgage interest to the Federal Land Bank as security for his personal obligation on the $200,000 bond, New York Real Property Law § 254(5) (McKinney's 1966) and, in the event of a deficiency in the security upon default of his

(footnote 2, continued)
event of petitioner's personal tax deficiency. See 26 U. S. C. §§ 6321 and 6323, and apply *State* law in determining petitioner's property interests. *Aquilino v. United States*, 363 U. S. 509, 513 (1960); *Tillery v. Parks*, 630 F. 2d 775 (10th Cir. 1980).

obligation to the Bank, petitioner was the only one who was liable for such deficiency, New York Real Property Actions and Proceedings Law § 1371 (McKinney's 1979), with no recourse to IX Investors.

In finding that the risks and consequences to petitioner as owner of the real property were, in the words of the Court of Appeals, "more imagined than real," both Courts below and the Commissioner have opened an avenue of serious uncertainty in the administration of the tax laws of the United States. A taxpayer, such as petitioner, will be in the unenviable position of acquiring certain economic rights and obligations and of facing certain economic risks and consequences under State statutory and case law and, without further guidance from

either the Internal Revenue Code or the regulations promulgated thereunder, find those risks shrugged off by the Commissioner as imagined, unreal and more formal than substantial.

II. THE DECISION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT IN THE INSTANT CASE IS IN SEEMING CONFLICT WITH THE DECISION OF THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT IN *MURRY v. COMMISSIONER OF INTERNAL REVENUE*, 601 F. 2d 892 (1979), AND OTHER CASES IN THE FIFTH CIRCUIT CONCERNING THE EFFECT OF STATE LAW IN DETERMINING TAXABLE INCIDENCE.

The United States Court of Appeals for the Fifth Circuit aptly posed the problem raised in the instant case by the Commissioner's attempt to disregard petitioner's legal jeopardy under State law:

> "We have no doubts that, as an initial matter, the Commissioner has the power to look behind the form of a transaction to

determine its true substance. We are asked to embark upon a new course altogether, giving the Commissioner the authority to restructure a transaction into the transaction the Commissioner would deem more appropriate. Such authority in government would be wholly unprecedented.

* * * The Commissioner's position is that when a taxpayer or related taxpayers have entered into actual transactions, the Commissioner should be authorized to rule that the taxpayer ought not to have made those particular transactions but should have entered into different transactions so that more immediately taxable income would result. Under this view, when the Commissioner determines that the taxpayer has, in a bona fide transaction, minimized tax consequences, Section 61 of the Internal Revenue Code authorizes the Commissioner to create the sort of transaction which would have maximized the taxable consequences and, having done so, to treat the taxpayer

> as if he had, indeed, entered into the transaction the Commissioner prefers."

Murray v. Commissioner of Internal Revenue, 601 F. 2d 892, 893 (5th Cir. 1979).

In the instant case, the United States Court of Appeals for the Second Circuit has, in fact, done what the United States Court of Appeals in *Murry, supra*, refused to do. The Court of Appeals for the Second Circuit in the instant case, agreeing with the Commissioner, transformed a less taxable transaction (the purchase, mortgage and sale of property by petitioner) into a more taxable one (a fee received for financing). There is no doubt that the petitioner herein entered into *actual* transactions, not only with IX Investors, but with the Federal Land Bank, with his predecessor in interest (the seller of the property) and

with the ultimate purchaser. All these transactions were real, substantive and bona fide, with all parties relying on those real, substantive, and actual features, but which the Commissioner did not "prefer." The Commissioner's approach, endorsed by the Second Circuit Court of Appeals in the instant case, goes beyond the "form over substance" approach and re-structures the transaction to a lender-borrower transaction. As such, the holding of the Court of Appeals for the Second Circuit is totally at odds with that of the Court of Appeals for the Fifth Circuit in *Murry, supra*.

Furthermore, in the instant case, the United States Court of Appeals for the Second Circuit has refused to consider the State law obligations and consequences flowing out of the property

transactions involved herein, a review which other Federal Appellate Courts have found necessary to determine tax incidence, see, e.g., *Watson v. Commissioner of Internal Revenue*, 613 F. 2d 594 (5th Cir. 1980) (Texas statutes apply in determining when a commercial obligation is fixed and the taxable effect of a letter of credit); *Bagur v. Commissioner of Internal Revenue*, 603 F. 2d 491 (5th Cir. 1979) (Louisiana statutes and case law dictate whether and what property rights and income were received by spouse, and Louisiana criminal law consulted to determine if property stolen for income tax purposes); *Salyersville National Bank v. United States*, 613 F. 2d 650 (6th Cir. 1980) (despite Commissioner's contention that taxpayer acted as an agent, Court found under Kentucky law, taxpayer bank

was not and could not become insurance agent).

If the decision of the United States Court of Appeals for the Second Circuit is left without review by this Court, an important question of Federal income taxation will be in conflict between the respective Courts of Appeals for the Fifth Circuit and Second Circuit.

III. THE DECISION OF THE COURT OF APPEALS FOR THE SECOND CIRCUIT IN THE INSTANT CASE, AFFIRMING THE DECISION OF THE TAX COURT, IS IN DIRECT CONFLICT WITH, AND A MARKED DEPARTURE FROM, THIS COURT'S DECISION IN *FRANK LYON COMPANY v UNITED STATES*, 435 U. S. 561 (1978), AND, UNLESS REVIEWED BY THIS COURT, MAY RESULT IN SUBSTANTIAL UNCERTAINTY IN THE ADMINISTRATION OF THE TAX LAWS OF THE UNITED STATES.

In *Frank Lyon Company v. United States*, 435 U. S. 561 (1978), this Court considered a sale-leaseback arrangement which the Commissioner had concluded was

a sham, entered into for purposes of tax avoidance. While the Tax Court had upheld the taxpayer, the United States Court of Appeals for the Eighth Circuit reversed and upheld the Commissioner's position.

In *Frank Lyon Company*, the Commissioner took the position that the taxpayer (Lyon) could not claim deductions for depreciation and interest paid on a building loan, since, when the "substance over form" rule was applied, the taxpayer was merely a conduit for an elaborate financing scheme for the benefit of another party, Worthen. The Commissioner claimed that the sale-leaseback agreement between Lyon and Worthen was only a financing scheme designed to provide economic benefit to Worthen and a guarantee return to Lyon. In essence, the Commissioner found

that Lyon, being personally liable on a mortgage agreement to a third party, was not the true owner of the building for tax purposes, and that, in fact, Worthen was the true owner because, throughout the term of the lease, Worthen was acquiring equity.

This Court, in reviewing the transactions, re-affirmed the "substance over form" rule in taxation cases, 435 U. S. 572-573. In the case before it, this Court analyzed the situation of the taxpayer and Worthen held that "where, as here, there is a genuine multiple party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached,

the Government should honor the allocation of rights and duties effectuated by the parties." 435 U. S. 583-584.

In *Frank Lyon Company*, Worthen, a Bank, had originally decided to finance and construct a building through a certain financing arrangement. The original financing concept, however, was disapproved by the Arkansas Bank Department and the Federal Reserve System. Worthen then conceived a sale-leaseback arrangement which met the approval of both regulatory agencies. Under the sale-leaseback agreement, Lyon, who was on the Board of Directors of Worthen, would become title-holder to the proposed building, subject to the approval of a third-party mortgagee, and would become personally liable to that third-party mortgagee pursuant to a mortgage agreement. Lyon

would then lease the property to Worthen. The Arkansas Bank Department, in approving the arrangement, however, required that the sale-leaseback agreement provide that, at the end of the fifteenth year of the lease, Worthen could purchase the building at a set price.

This Court, in reviewing the arrangement, found what it believed to be significant indicia of economic substance, all of which indicia are present in the instant case. Worthen, like IX Investors, due to business and regulatory requirements, could not complete its original financing concept, so turned to Lyon. Lyon, the taxpayer, like the instant petitioner, was personally and solely liable on a bond and mortgage to a third-party, the proceeds of that mortgage being used in the arrangement between Worthen and Lyon. This Court stated:

> "No matter how the transaction could have been devised otherwise, it remains a fact that, as the agreements were placed in final form, the obligation on the notes fell squarely on Lyon. Lyon, an ongoing enterprise, exposed its very business well-being to this real and substantial risk.
>
> The effect of this liability on Lyon is not just the abstract possibility that something will go wrong and that Worthen will not be able to make its payments. Lyon has disclosed this liability on its balance sheet for all the world to see. Its financial position was affected substantially by the presence of this long-term debt, despite the offsetting presence of the building as an asset." 435 U. S. 577.

Worthen, like IX Investors, was under no legal obligation to repay Lyon for amount contended by the Government to have been a mere loan. 435 U. S. 579.

Lyon had, in fact, become titleholder solely for the reason that it was so required by the regulatory agencies and by the mortgagee party, just as petitioner herein became title holder by virtue of the Federal Land Bank's requirements.

In short, the factual posture in *Frank Lyon Company* is remarkably similar to that in the instant case. This Court found that, upon the facts, there was a great deal of economic substance, consequence and risk to the taxpayer, despite the Commissioner's finding that it was a "sham" transaction, more formal than substantive. Those same facts are present herein, and it is evident that the transaction involved in the instant matter, as Judge Mansfield stated in his dissenting opinion in the Court below, created real and substantial consequences

to the taxpayer. To permit the decisions of the Tax Court and the United States Court of Appeals for the Second Circuit to remain without review by this Court would cast considerable uncertainty as to the effect and meaning of the decision in *Frank Lyon Company v. United States*, and would undermine the lawful and effective administration of the tax laws of the United States.

CONCLUSION.

FOR ALL OF THE ABOVE REASONS, IT IS RESPECTFULLY PRAYED THAT THE WRIT OF CERTIORARI BE GRANTED.

Respectfully submitted,

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Attorney for Petitioner,
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(914) 471-6121.

MICKEY A. STEIMAN,
Of Counsel.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 234—September Term, 1980

(Argued October 16, 1980 Decided February 24, 1981)

Docket No. 80-4103

WILLIAM J. O'HARE and PATRICIA E. O'HARE,

Appellants,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

Before:

FRIENDLY, MANSFIELD and MESKILL,

Circuit Judges.

Appeal from a decision of the United States Tax Court ruling that certain income was ordinary income and not long term capital gain.

Affirmed.

MICKEY A. STEIMAN, Poughkeepsie, New York (William J. O'Hare, Poughkeepsie, New York, of counsel), *for Appellants.*

WILLIAM A. FRIEDLANDER, Tax Division, Department of Justice, Washington, D.C.

(M. Carr Ferguson, Assistant Attorney General, Washington, D.C., Michael L. Paup, Richard Farber, Tax Division, Department of Justice, Washington, D.C., of counsel), *for Appellee.*

MESKILL, *Circuit Judge:*

William and Patricia O'Hare appeal a decision of the United States Tax Court, Quealy, *J.*, upholding a deficiency assessment of $10,131 for the taxable year 1974.[1] The sole question on this appeal is whether $40,000 received in connection with the sale of certain property should be taxed as ordinary income or long term capital gain. The Tax Court determined that under the circumstances the money should be treated as ordinary income. We affirm.

BACKGROUND

The relevant facts are fully set forth in the opinion of the Tax Court and are largely undisputed here. During the years 1973 and 1974, IX Investors, Inc. (Investors) was a New York corporation engaged in the business of buying and selling real estate. In late 1973 Investors entered into a contract to buy an upstate New York farm for $248,000. Investors made a down payment of $24,800 and immediately began searching for financing for the balance. When Investors encountered difficulty in finding a lender, Richard Dean, its president, approached O'Hare, the com-

[1] Patricia O'Hare is an appellant here solely because she filed a joint return with her husband, William. For simplicity, the claims of William (hereinafter referred to as "O'Hare" or "taxpayer") will be treated as the claims of both.

pany's lawyer, and stated that Investors was willing to pay up to $70,000 "off the top" of the sale proceeds to anyone providing financing for the farm. Shortly thereafter, a local New York bank indicated that it would be interested in providing the financing, but, in light of Investors' financial statement, insisted that someone of "sufficient net worth" cosign the mortgage note. At the request of Investors, O'Hare agreed to cosign the note. But after reviewing O'Hare's financial statement, the bank decided to require O'Hare personally to take title to the property. Accordingly, on December 28, 1973, Investors and O'Hare executed an agreement to enable O'Hare to take title while Investors searched for a buyer, and to provide for transfer after that event. This agreement spawned the present dispute.[2]

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2 The agreement provided in pertinent part as follows:

WHEREAS, the party of the first part [Investors] in consideration of ONE DOLLAR and other valuable consideration hereby agree to assign their rights, interests and obligations in said contract to William J. O'Hare.

WHEREAS, the party of the first part and the party of the second part [O'Hare] have mutually agreed to the purchase and sale of this property in accordance with the understandings hereinafter mentioned, agree to the following:

1. That the party of the second part agrees to personally obtain and sign the necessary papers to personally attain a $200,000.00 mortgage on the above-mentioned property in its individual name.

2. That the party of the first part will pay at the time of the closing the difference between the purchase price of $248,000.00 minus the down-payment of $24,800.00 and all other expenses incidental to the closing of title, including but not limited to taxes, expenses for recording instruments, bank fees, legal fees, and all other expenses to facilitate the transfer of title.

3. That the party of the second part will agree at the time of a future sale to reconvey the property back to the party of the first part on the following terms and conditions:

a. That if the property is reconveyed within a four (4) month period from the date of the closing from the Ferrys to William J. O'Hare, the party of the second part will reconvey the property

Under the terms of the agreement, Investors agreed to assign to O'Hare its right to purchase the farm and O'Hare agreed to obtain in his own name a mortgage of $200,000 on the farm. When a third party buyer was found, O'Hare was to reconvey the property to Investors upon the latter's satisfaction of the mortgage and payment of a lump sum determined by the length of time the property was held: $25,000 if the property was sold within four months, $50,000 if sold between four and eight months, and $75,000 if sold after eight months. The payments to O'Hare were not contingent upon Investors' realizing a profit. No provision was made for sharing a loss. O'Hare was prohibited from encumbering the farm, other than by executing the $200,000 mortgage, without Investors' consent. Shortly after this agreement was entered into, O'Hare personally signed a $200,000 note to the bank, took title to the property, and executed a mortgage in favor of the bank to secure the note. Investors paid the transactional costs, including attorney's fees. Although the agreement was silent as to who was responsible for paying the mortgage interest and the taxes on the property, Investors in fact paid both.

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upon the payment of $25,000.00 and the satisfaction of the $200,000.00 mortgage above-mentioned.

b. If the property is reconveyed within a four (4) to eight (8) month period, the party of the second part will reconvey the property upon the payment of $50,000.00 and the satisfaction of the $200,000.00 mortgage above-mentioned.

c. If the property is reconveyed after an eight (8) month period, the party of the second part will reconvey the property upon the payment of $75,000.00 and the satisfaction of the $200,000.00 mortgage above-mentioned.

4. That the party of the second part agrees and mutually promises with the party of the first part that he will not encumber the property above-mentioned with additional or new mortgages without the consent of both parties.

In August 1974, Investors located a buyer and the property was sold for $335,000.[3] Although O'Hare was entitled by the terms of the agreement to keep $50,000, he agreed to settle for $40,000 so that Investors could realize some profit on its investment. On their joint return for 1974, the O'Hares reported the $40,000 as long term capital gain from the sale of a capital asset.[4] The IRS determined that the sum was a fee for obtaining financing and was therefore ordinary income. The Tax Court upheld the IRS, and O'Hare appeals.

DISCUSSION

O'Hare concedes that the substance rather than the form of the transaction governs tax treatment, *see Commissioner v. Court Holding Company,* 324 U.S. 331, 334 (1945), but insists that the substance of this deal was "in the nature of a joint venture." In support of this position, O'Hare points out that the assignment did not indemnify him against liability for carrying charges on the property, nor against liability for accidents occurring on the property, nor against loss in the event Investors never sought or obtained a third party buyer. Investors would not sell unless it could realize a profit, and O'Hare would not receive any money unless Investors sold. O'Hare also

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3 Although the agreement provided that Investors should buy the property from O'Hare and then sell to the buyer, the parties apparently decided to bypass this procedure by having O'Hare sell directly to the buyer. We do not feel that this short cut materially affects the legal issues here involved.

4 At the time of this transaction, the holding period for long term capital gain treatment was six months. *See* I.R.C. § 1222(3) (1974), subsequently amended by the Tax Reform Act of 1976, P.L. 94-455 (1976) (changing holding period from six months to nine months for calendar year 1977 and to one year effective after December 31, 1977).

claims that if the property was sold for less than $200,000, he would have had to use his own funds in addition to the sales proceeds to satisfy the mortgage. Thus, O'Hare argues, he was sufficiently involved with the profitability of the venture to warrant treatment as a joint venturer.

The Tax Court was unimpressed with these arguments. Finding that O'Hare "never had any intention of buying the property in his own right," the court concluded that he took title to the property only because that was a requirement of the loan transaction. He contributed none of his own funds, other than the loan which was obtained on the strength of his credit and which required no out-of-pocket expenditures. As for his risks, the Tax Court found them more imagined than real, and not materially different from those borne by other lenders. Finally, the court found that the payment schedule militated against a finding of co-ownership, since the fee was contingent upon the holding period rather than any gain resulting from the sale of the property. Thus, the court concluded that O'Hare "merely received a fee" for providing the funds to buy the property, and that the fee was taxable as ordinary income.

The factual findings and inferences of the Tax Court are considered under a "quite restricted" standard of review and must be given "primary weight," *Commissioner v. Duberstein*, 363 U.S. 278, 289-91 (1960), whereas its legal conclusions are entitled to no such deference. We decline to enter the debate of whether the assailed conclusions of the Tax Court were factual inferences or legal conclusions, *see Weddle v. Commissioner*, 325 F.2d 849, 851 (2d Cir. 1963), since we agree on both the facts and the law that the $40,000 was essentially a fee for the use of O'Hare's credit rather than "gain"

from the sale of a capital asset. *See Comtel Corporation v. Commissioner,* 376 F.2d 791, 795-96 (2d Cir.), *cert. denied,* 389 U.S. 929 (1967).

We start with common ground. No one would dispute that if O'Hare had simply given his guarantee, as originally planned, and had received a fee for doing so, the money would be ordinary income. Nor could anyone seriously contend that the mere holding of legal title, without more, is sufficient to assure capital gain treatment. *See Comtel Corporation v. Commissioner, supra,* 376 F.2d at 796-97. Such a rule would exalt form over substance and would provide a ready means for those seeking to achieve the tax benefits of true investment without incurring the usual risks. Rather, the question is whether O'Hare's holding of title, together with his financial exposure in the event that the property was sold for less than $200,000, or, indeed, was never sold at all, essentially converted O'Hare from a mere guarantor into a joint venturer.

We think the Tax Court was amply justified in concluding that the claimed risks did not convert O'Hare into a joint venturer. O'Hare enjoyed a considerable measure of personal protection by virtue of the $48,000 which Investors had paid above the $200,000 mortgage. The extent of Investors' investment in the property surely helped minimize the risk that the company would simply walk away from the deal or fail to exercise due diligence in pursuing a third party buyer, and is an indication that it was thought unlikely that the property would be sold for less than $200,000. Furthermore, even though the assignment did not indicate that Investors would pay the carrying charges on the property, that Investors did pay these costs certainly suggests that this was in fact the understanding. Finally, the Tax Court was justified in inferring that the payment schedule undermined O'Hare's joint

venture claim. It is hardly likely that a true owner or joint venturer would agree to an arrangement whereby his profit depended upon the timing of the sale rather than the amount of the proceeds of the sale. Such a payment mechanism clearly suggests a fee for the use of credit rather than a gain from the sale of property.

The present case is legally indistinguishable from *Comtel Corporation v. Commissioner, supra,* where this Court upheld the Tax Court's rejection of the taxpayer's capital gains argument. In *Comtel,* the Zeckendorf Corporation had the opportunity to acquire a controlling block of shares in the Hotel Commodore, but had been unable to secure financing. Zeckendorf eventually approched two potential lenders and, with them, formed the Comtel Corporation. Comtel then obtained a loan, Zeckendorf used the loan proceeds to buy the stock, and then Zeckendorf sold the stock to Comtel for the exact purchase price, retaining an option to repurchase the stock shortly after the capital gains holding period was satisfied. The "repurchase price" was to include Comtel's acquisition price, all of Comtel's expenses in the matter, including organizational and liquidation expenses, a six percent return on Comtel's capital investment, and a sizable lump sum. The arrangement went as planned: Zeckendorf found a new lender and repurchased the shares from Comtel. The Tax Court refused to recognize the elaborate scheme as a stock purchase and resale, holding that in substance the transactions were "merely steps in a complex, prearranged financing plan." 45 T.C. 294, 304 (1965).

In affirming, we placed particular emphasis on five findings of the Tax Court. First, Zeckendorf never wavered in its desire to acquire the Commodore stock and never intended Comtel to displace it as the true owner. Second, the investors in Comtel Corporation were pri-

marily interested in a high yield, low risk investment, rather than in hotel ownership or operation. Third, Comtel was not permitted to sell or dispose of the Commodore stocks. Fourth, Comtel's profit depended solely on a prearranged option price, not on appreciation in the value of the stock. Fifth, the repurchase price had two variable components: Comtel's expenses in the matter and interest on principal--typical characteristics of compensation for the use of another's money.

The similarities to the present case are more than superficial. Like Comtel, O'Hare never intended to be more than a temporary accommodation holder of title to satisfy the loan requirements of the bank, and the extent of Investors' cash investment helped ensure that Investors would make every effort to see that O'Hare's intentions were realized. Investors continued to pay the carrying costs and to search for a buyer.[5] O'Hare's entirely passive role indicates that he did not intend to acquire the farm as a capital investment, but only as a means for obtaining compensation for his financial services. That O'Hare was not permitted to encumber the property and was not permitted to share in any of the profits above his prearranged fee militates against a finding that he was in essence a joint venturer. The only factual difference we see between this case and *Comtel* is that here O'Hare claimed that he assumed the risk of loss should the proceeds from the sale of the property fail to cover the mortgage principal. This does not change our conclusion, however, since, as the Tax Court noted, the risk assumed

5 O'Hare asserts, apparently for the first time, that he also actively sought a buyer. The record fails to disclose that he took any action in this regard, and indeed shows that he did no more than wait passively while Investors sought a buyer. The Tax Court was fully justified in stating that the third party buyer was located "[a]s a result of the efforts of" Investors.

by O'Hare did not differ significantly from that assumed by a lender to a non-recourse borrower. Thus, the Tax Court was fully justified in inferring that the "total effect" of the real estate transaction here in question was that of a financing scheme rather than a joint venture. *See Comtel Corporation v. Commissioner, supra,* 376 F.2d at 797.

Judgment affirmed.

MANSFIELD, *Circuit Judge* (Dissenting):

I respectfully dissent. In my view the increased risks assumed by O'Hare as borrower from the bank and as titleholder of the property justify treatment of him as a joint venturer rather than as a guarantor or lender to whom a fee was to be paid for obtaining financing.

Had O'Hare remained a mere guarantor on a loan to Investors, any payment he received in compensation for that service would undoubtedly have been ordinary income. However, O'Hare's position as borrower and titleholder exposed him to risks from which he would have been immune as guarantor: (a) the risk that the property could not be sold or that it would be sold for less than $200,000, and (b) the risk that a large liability to a third party would arise from the property itself. In either of these events he would have had no right to reach the assets of Investors and its partners, something he could have done as guarantor.

The majority argues that these risks, although perhaps theoretically present, were properly dismissed by the Tax Court, because: (a) Investors' $48,000 investment in the property and its willingness to pick up the loan's carrying costs during the sale period minimized the chance that

Investors would simply abandon O'Hare, and (b) the payment schedule adopted by the parties had the effect of eliminating the typical joint venturer's dependence on ultimate profitability.

With the benefit of hindsight, it is easy to argue that O'Hare's risks were minimal, and that Investors was so involved financially in the property that it was unlikely to abandon the venture. However, the risk element of O'Hare's position must be evaluated as of the time when he agreed to become borrower and titleholder, rather than after a successful sale was arranged. When the facts surrounding the deal are examined from this perspective, a very different picture emerges.

The venture proposed by Investors was considered so risky by the local financial community that Investors was unable to obtain financing from any source, even though "many institutions" and "many different people" were approached. Investors' offer to pay $70,000 to anyone who could arrange financing was also unsuccessful. When the Federal Land Bank finally agreed to make the loan, it refused to do so with O'Hare as guarantor, and instead required him to become solely liable on the note. This contemporaneous evaluation by a local expert that O'Hare's exposure to the bank would be significantly greater as borrower than as guarantor is strong evidence that the majority's retrospective assessment of the situation is erroneous. Moreover, Investors (recklessly, as it seemed to others at the time) had entered into a $248,000 purchase contract and made a $24,800 downpayment without first securing mortgage financing. Finally, at the time O'Hare agreed to take the property in his own name, there was no immediate prospect of a sale; in fact, it took Investors the better part of a year to sell the property in question. On this record, I fail to see how Judge Quealy

could properly conclude that "resale and conveyance on terms negotiated by Investors was a practical certainty." It clearly was not. For these reasons the majority in my view errs in concluding that O'Hare was no more exposed as borrower and titleholder than he would have been as guarantor.

In relying on the payment schedule contained in the agreement between O'Hare and Investors, the majority also exalts form over substance. It is significant that the payment formula originally arrived at by the parties was not observed in fact. Instead of paying O'Hare the $50,000 to which he would have been entitled under the formula, the parties instead agreed to lower O'Hare's payment to $40,000 specifically in order to allow Investors to show an adequate profit on the transaction. We should be governed in this matter by what the parties did, not by what they said they were going to do. Since the parties interpreted their own agreement as conditioning O'Hare's payment on the deal being profitable for both parties, I would conclude that the payment schedule was never intended by the parties to insulate O'Hare from the vagaries of the market.[1]

Perhaps the clearest proof that the Tax Court misinterpreted the factual situation presented by this case is its statement that O'Hare did not assume any increased risk of loss by becoming the borrower and titleholder because

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[1] Even when the inquiry is limited to the language of the agreement itself, the evidence as to whether O'Hare's payment was meant to be tied to profitability is at least ambiguous: while specific payment figures are mentioned for each time period, the agreement also provides that, in the event the property is sold a piece at a time, O'Hare would receive upon each sale a "payment of his agreed *profits*." (Emphasis supplied). It is therefore not unreasonable to conclude that the parties understood from the beginning that O'Hare's payment would be conditioned upon the profitability of the transaction.

"petitioner's risk did not differ from that of any lender." Since a typical mortgage lender (such as the Federal Land Bank in this case) demands the personal guarantee of the buyer (or a prosperous guarantor) in addition to taking a security interest in the property being acquired, it is obvious that O'Hare's position as owner was *not* like that of a typical lender. If O'Hare had loaned $200,000 to Investors on a note and taken a security interest in the farm, Investors would have remained liable to him regardless of whether or not the farm was ever sold. By contrast, as owner of the property O'Hare had no right to proceed against anyone, and would have had to content himself with salvaging something from the farm itself if the proposed sale had never taken place.

The majority tries to explain away this error by suggesting that the Tax Court must have meant to say no more than that O'Hare's position as borrower was identical to that of a lender in a *non-recourse* situation. While this seems most unlikely, even if we assume the non-recourse characterization *arguendo*,[2] it cuts strongly against the position adopted by the majority. O'Hare would have been far more secure as guarantor than as a non-recourse lender, because in the latter case O'Hare would have had no right over against the borrower but would have had his recovery limited to the resale value of the collateral itself. In the latter circumstances a default occurs when the collateral turns out to be worth less than what the borrower paid for it (and thus cannot be resold at a profit). Non-recourse lending therefore makes sense only

2 Note, however, that O'Hare's position here was in fact somewhat worse than that of a lender on a non-recourse note. Whereas a non-recourse lender faces no direct liability for claims arising out of the collateral prior to default and foreclosure, O'Hare's posture here was quite different, since to the rest of the world he was the owner of the property in question prior to sale.

where the collateral pledged is so easily disposed of at a price equal to or exceeding the amount of the loan that the addition of a personal or corporate guarantee would be superfluous. In contrast, under the circumstances of this case, where the "collateral" consists of land of dubious value, not easily liquidated, the position of a non-recourse lender would be hazardous in the extreme. Thus, if O'Hare were properly characterized as occupying a risk position no better than that of a non-recourse lender, his risk was sufficient to qualify him as a joint venturer.

The majority's reading of *Comtel* is unpersuasive. The first two factors relied on by the *Comtel* court focused on the sharp contrast which the court found between the short-term no-risk investment mentality of Comtel and the buy-and-hold spirit of Zeckendorf, a contrast which the court argued militated against capital gains treatment for the party with the more limited commitment.[3] Here, in contrast, neither party ever had any intention of going into the farming business. Both parties were seeking high-yield, risk-proof investments. The *Comtel* reasoning on these two points is therefore irrelevant.

With respect to the third factor relied on by the *Comtel* court, the fact that O'Hare did not have the right to encumber the farm at will prior to sale hardly proves that the transaction taken as a whole was not a joint venture. By prohibiting second mortgages on the farm, Investors was merely guaranteeing that O'Hare would not take personal advantage of what was really a joint asset and that the property would be available for immediate resale when the time came. This restriction on O'Hare's owner-

[3] There can be no dispute that at least one of the two parties to the transaction in the present case is entitled to capital gains treatment.

ship of the farm was nothing more than a cautionary step taken by a prudent joint venturer. Since O'Hare makes no claim that the transaction was to be his alone, it is of no matter that his joint venturer was unwilling to place in O'Hare's hands the power to take improper advantage of his joint status.

The fourth factor in *Comtel* supports O'Hare's position here. Whereas Comtel's profit was precisely fixed and independent of any contingent event (since a complex network of subordination and indemnity agreements created a structure wherein the investors' "risk of loss was practically eliminated," 376 F.2d at 793), here the behavior of the parties clearly indicates that O'Hare's final payment was in fact tied to the profitability of the resale. Similarly, the fifth factor cannot be read as supporting the Government's position here, since Investors' obligation to repurchase was not of short duration and was not in fact viewed by the parties as depending exclusively on the passage of time. Whereas the holding period in *Comtel* was as long as seven months only because of the exigencies of the short-swing profits rules, here O'Hare's obligation was indefinite in nature. Even the payment schedule on which the majority places such emphasis was a far cry from the banker-style formula employed in *Comtel*. When one considers the fact that even the very rough payment schedule in the present case was altered by the parties in order to make the deal profitable for both, the contrast with *Comtel* becomes clear. Finally, whereas in *Comtel* Zeckendorf was as a practical matter compelled to exercise its option, here a profitable resale was far from guaranteed, for reasons discussed above.

I am forced to conclude that the majority has misunderstood the extent of O'Hare's exposure prior to sale, and has distorted the *Comtel* analysis in order to fit the facts of this case. For the reasons stated I would reverse the Tax Court's decision.

APPENDIX B.

T. C. Memo. 1980-34

UNITED STATES TAX COURT

WILLIAM J. O'HARE and PATRICIA E. O'HARE, Petitioners v. COMMISSIONER OF INTERNAL REVENUE

Docket No. 6384-78.

Filed February 6, 1980.

William J. O'Hare, *pro se*.

Christopher B. Sterner, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION.

QUEALY, *Judge*: Respondent determined a deficiency in income tax due from the petitioners for the taxable year 1974 in the amount of $10,131. The sole question for decision is whether the gain of $40,000 realized in connection with the purchase and resale of certain property

is taxable as ordinary income or should be treated as a long-term capital gain.

FINDINGS OF FACT.

Some of the facts have been stipulated. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

The petitioners William J. and Patricia E. O'Hare filed a joint Federal income tax return for the taxable year 1974 with the Director, Internal Revenue Service Center, Andover, Massachusetts.[1] Petitioners resided at Lagrangeville, New York, at the time the petition in this case was filed.

During the taxable year 1974, and at the time of the trial of this case,

1. Patricia E. O'Hare is a petitioner herein solely by reason of having filed a joint return.

William J. O'Hare (hereinafter referred to as petitioner) was an attorney at law duly admitted to practice before the courts of the State of New York and maintained a law office in Poughkeepsie, New York.

During the years 1973 and 1974, IX Investors, Inc. (hereinafter referred to as "Investors") was duly incorporated pursuant to the laws of the State of New York and was principally engaged in the business of buying and selling real estate. Richard Dean was then president of Investors. As such, he was responsible for determining what real estate transactions Investors would enter into and for arranging the execution of such transactions. During the years 1973 and 1974, petitioner was corporate attorney for Investors.

On or about November 21, 1973, Investors entered into a contract for the purchase of certain real estate known as "Ferry Farm," located in the Town of Livingston, County of Columbia and State of New York, at a price of $248,000. Investors paid the sellers $24,800 as a down payment upon execution of the contract.

At that time, Investors planned to obtain a mortgage loan of $200,000 to finance the purchase of Ferry Farm. However, Investors initially was unable to secure this loan.

Mr. Dean subsequently requested that petitioner attempt to secure financing for the purchase of Ferry Farm and indicated that Investors would be willing to pay as much as $70,000 off the top of the proceeds of the future sale of Ferry Farm

to anyone who would provide financing for the purchase. However, Investors was still unable to secure financing for the purchase of Ferry Farm.

Mr. Dean then contacted the Federal Land Bank in Hudson, New York, regarding financing and was informed by the bank that it would be interested in supplying the required money. After reviewing the financial statement of Investors, the Federal Land Bank stated that it would require that someone of sufficient net worth to guarantee the mortgage loan co-sign the mortgage note.

At the request of Mr. Dean, petitioner agreed to cosign the mortgage loan from the Federal Land Bank. After the bank reviewed petitioner's financial statement, it indicated that before it could supply the needed financing,

petitioner would be required personally to take title to the property.

On or about December 28, 1973, Investors entered into a written agreement with petitioner which provided that Investors would assign its rights under the contract to purchase the Ferry Farm to petitioner in return for which petitioner would obtain a mortgage commitment for $200,000, purchase the property in his own name and reconvey the Ferry Farm to Investors when a third party buyer for the property had been secured.

In consideration for obtaining the $200,000 mortgage loan, petitioner was to receive a predetermined fee from Investors when the property was sold. Said fee was directly related to the period of time petitioner held title to the property. Petitioner would receive

$25,000 if he held title for less than four months, $50,000 if he held title for four or more but less than eight months, and $75,000 if he held title for more than eight months.

The payments were not contingent on the realization of a profit by Investors from the future sale of the property. The agreement made no provision for the sharing of any loss. Investors was to pay off the $200,000 mortgage loan. The agreement also provided that Investors would pay all expenses incurred in connection with the property. Except for the original $200,000 loan, petitioner was prohibited from encumbering the property without the consent of Investors.

Petitioner obtained the mortgage loan from the Federal Land Bank in the amount of $200,000 and purchased Ferry

Farm in his name for the price of $248,000. Investors paid all expenses relating to the purchase other than the $200,000.

During the period of time that petitioner held title to the property, all expenses relating to the management and operation of the property, including real estate taxes and interest payments to the Federal Land Bank on the $200,000 loan, were paid by Investors. Petitioner did not participate in the management or the operation of the property.

As a result of the efforts of Mr. Dean, on behalf of Investors, on or about August 14, 1974, Ferry Farm was conveyed to a third party for a purchase price of $335,000.

In accordance with the agreement for the original financing of the property, petitioner was entitled to receive

$50,000 from Investors. However, petitioner agreed to settle for $40,000 because Investors would have realized no profit on the entire Ferry Farm transaction if it was required to pay petitioner $50,000.

On Schedule D of their joint income tax return for the taxable year 1974, the petitioners reported the $40,000 received from Investors during 1974 as a long-term gain from the sale of a capital asset. Respondent would tax such amount as ordinary income.

OPINION.

Investors had a contract to purchase certain property for $248,000. Investors had made a down payment of $24,800 but lacked sufficient funds to complete the purchase. Investors sought to obtain a

mortgage loan of $200,000 but was unsuccessful. Petitioner, who acted as counsel for Investors, thereupon undertook to obtain the loan. After some negotiations, the lender agreed to make the loan if the property was put in the name of petitioner and the petitioner became the obligor.

Investors and petitioner entered into an agreement whereby in consideration for obtaining the loan, petitioner would receive a stated amount upon the anticipated resale of the property predicated upon the length of time that the loan was outstanding. Investors paid the balance of the purchase price, interest, taxes and all other expenses relating to the property. When Investors was successful in obtaining a purchaser for the property, the proceeds were used to pay

off the loan, pay petitioner a $40,000 agreed upon "fee", and Investors kept the balance.

To state the facts, which are not in dispute, is to resolve the issue. Petitioner merely extended his "credit" to Investors, for which he received a fee. While petitioner held title to the property, he did so as a part of the loan transaction. Petitioner never had any intention of buying the property in his own right and contributed none of his own funds, other than the loan. Investors not only paid the balance of the purchase price, but paid all other costs and expenses.

Petitioner argues that he assumed the "risk of loss," that is the risk of nonpayment of the loan, and therefore should be treated as having an interest

in the property. However, petitioner's risk did not differ from that of any lender. When the property was resold, the consideration received by petitioner was not measured by any resulting gain from the sale of the property but by the time that the loan had been outstanding. Petitioner merely received a "fee" for providing $200,000 of the funds used to buy the property. As such, the fee is taxable as ordinary income. *Comtel Corp. v. Commissioner*, 45 T. C. 294 (1965), affd. 376 F. 2d 791 (2d Cir. 1967), cert. denied 389 U. S. 929 (1967).

Decision will be entered for respondent.

APPENDIX C.

NEW YORK STATE STATUTES.

NEW YORK GENERAL OBLIGATIONS LAW, SECTIONS 13-105 AND 13-109.

§13-105. Effect of transfer of claim or Demand.

Where a claim or demand can be transferred, the transfer thereof passes an interest, which the transferee may enforce by an action or special proceeding, or interpose as a defense or counter-claim, in his own name, as the transferrer might have done; subject to any defense or counter-claim, existing against the transferrer, before notice of the transfer, or against the transferee. But this section does not apply, where the rights or liabilities of a party to a claim or demand, which is transferred, are regulated by special provision of law; nor does it vary the rights or

liabilities of a party to a negotiable instrument, which is transferred.

§13-105. Definition of "transfer."

As used in sections 13-101, 13-103, 13-105 and 13-107, the term "transfer" includes sale, assignment, conveyance, deed and gift.

NEW YORK REAL PROPERTY LAW, SECTION 244.

§244. When grant takes effect.

A grant takes effect, so as to vest the estate or interest intended to be conveyed, only from its delivery; and all the rules of law, now in force, in respect to the delivery of deeds, apply to grants hereafter executed.

NEW YORK LIEN LAW, SECTION 2(3).

§2. Definitions.

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3. Owner. The term "owner," when used in this chapter, includes the owner in fee of real property, or of a less estate therein, a lessee for a term of years, a vendee in possession under a contract for the purchase of such real property, and all persons having any right, title or interest in such real property, which may be sold under an execution in pursuance of the provisions of statutes relating to the enforcement of liens of judgment, and all persons having any right or franchise granted by a public corporation to use the streets and public places thereof, and any right, title or interest in and to such franchise. The purchaser of real property at

a statutory or judicial sale shall be deemed the owner thereof from the time of such sale. If the purchaser at such sale fails to complete the purchase, pursuant to the terms of the sale, all liens created by his consent after such sale shall be a lien on any deposit made by him and not on the real property sold.

NEW YORK REAL PROPERTY LAW,
SECTION 240-b(1).

§240-b. Certain conveyances authorized; effect thereof.

1. Any person or persons owning real property or an interest in real property which he or they have power to convey, may effectively convey such property or interest by a conveyance naming himself or themselves and another person or persons, or one or more of themselves and another person or other persons, as

grantees, and the conveyance has the same effect as to whether it creates an estate in severalty, a joint tenancy, or a tenancy by the entirety, or tenancy in common, as if it were a conveyance from a stranger who owned the property or interest to the persons named as grantees in the conveyance.

NEW YORK ESTATE, POWERS AND TRUST LAW, SECTION 1-2.6.

§1-2.6. Estate.

Depending upon the context, "estate" may mean:

(a) The interest which a person has in property.

(b) The aggregate of property which a person owns.

NEW YORK REAL PROPERTY TAX LAW,
SECTIONS 926(1) AND 926(5).

§926. Personal liability for taxes; optional method of collection.

1. The owner of real property, or of an interest therein, if a resident of the city or town in which such property or interest therein is assessed and if his name is correctly entered on the roll, shall be personally liable for the taxes levied thereon. The term "resident" shall include a corporation having within such city or town a place for the regular transaction of business or in actual possession of real property therein.

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5. If upon application of a collecting officer or the county treasurer, it appears that taxes on a parcel of real property cannot be collected because the

owner personally liable therefor has moved to another county in the state, the county court shall issue an order directed to the sheriff of such other county to collect such taxes with interest at the rate of eight per centum per annum from the date of the order by levy and sale of the personal property of such owner. Such order shall be filed in the office of the clerk of the county in which it was granted and a certified copy thereof delivered to the sheriff of such other county. Upon receiving such order, the sheriff shall comply therewith and shall be entitled to the same fees and subject to the same liabilities and penalties for neglect as in the case of an execution from a court of record. The sheriff shall pay the net amount received to the county treasurer of the

county from which the order was issued who shall credit such amount to the appropriate city or town.

NEW YORK REAL PROPERTY LAW,
SECTION 254(5).

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5. Mortgager to warrant title. A covenant "that the mortgagor warrants the title to the premises," must be construed as meaning that the mortgagor warrants that he has good title to said premises and has a right to mortgage the same and that the mortgagor shall and will make, execute, acknowledge and deliver in due form of law, all such further or other deeds or assurances as may at any time hereafter be reasonably desired or required for the more fully and effectually conveying the premises by the mortgage described, and thereby granted or intended

so to be, unto the said mortgagee, his executors, administrators, successors or assigns, for the purpose aforesaid, and unto all and every person or persons, corporation or corporations, deriving any estate, right, title or interest therein under the said indenture of mortgage, or the power of sale therein contained, and the said granted premises against the said mortgagor, and all persons claiming through him will warrant and defend.

NEW YORK REAL PROPERTY ACTIONS AND PROCEEDINGS LAW, SECTION 1371.

§1371. Deficiency judgment.

1. If a person who is liable to the plaintiff for the payment of the debt secured by the mortgage is made a defendant in the action, and has appeared or has been personally served with the

summons, the final judgment may award payment by him of the whole residue, or so much thereof as the court may determine to be just and equitable, of the debt remaining unsatisfied, after a sale of the mortgaged property and the application of the proceeds, pursuant to the directions contained in such judgment, the amount thereof to be determined by the court as herein provided.

APPENDIX D.

FEDERAL STATUTES.

26 U. S. C., SECTION 2031.

Sec. 2031. Definition of Gross Estate.

(a) General. - The value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated.

26 U. S. C., SECTION 2033.

Sec. 2033. Property in Which the Decedent had an Interest.

The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.